

# WATER REPLENISHMENT DISTRICT OF SOUTHERN CALIFORNIA

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## ***Although the District Has Eliminated Excessive Water Rates, It Has Depleted Its Reserve Funds and Needs to Further Improve Its Administrative Practices***

REPORT NUMBER 2000-016, MAY 2002

Water Replenishment District of Southern California's response as of November 2002

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### ***Audit Highlights . . .***

***Although the Water Replenishment District of Southern California (district) has lowered its accumulated reserve funds and assessment rate, it lacks a long-term vision of its financing needs. In addition, the district lacks adequate planning for its capital improvement projects and adequate accounting and administrative controls over its operating expenses. Specifically, our review revealed that the district:***

- Lowered its reserve funds from \$67 million in 1998 to a projected balance of \$6 million at June 30, 2002, without establishing a minimum level of funds necessary to meet its responsibilities.***
- Has not identified an optimum quantity of groundwater to be stored in the basins, although groundwater has dropped by 110,000 acre-feet.***

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The Water Replenishment District of Southern California (district) was established in 1959 to counteract the effects of overpumping the groundwater in the West Coast and Central basins (basins). The California Water Code (water code) grants the district broad powers to do what is necessary to replenish and maintain the integrity of the basins. In December 1999 the Bureau of State Audits (bureau) issued a report concluding that the district's poor management had led to its charging those who pump groundwater an excessively high replenishment assessment (assessment rate). Because that report raised significant issues, the Legislature amended the water code to ensure that the district implemented the bureau's recommendations. The amendments also required the bureau to perform this follow-up audit of the district's operations and management.

### **Finding #1: The district has significantly reduced its reserve funds and stored groundwater quantities have declined.**

One of the bureau's 1999 recommendations was that the district should reduce its reserve funds, which totaled \$67 million in 1998. The district responded by lowering its reserve funds to a projected balance of slightly more than \$6 million by June 30, 2002. We believe that this significant depletion may pose a threat to the district's ability to maintain the current quantity of groundwater in the basins. The district uses its reserve funds to ensure an adequate supply of groundwater, to stabilize its assessment rate, and to develop capital improvement projects that increase the reliable supply of clean groundwater in the basins. In spite of the current low level of reserve funds, the district has not established a minimum level of funds necessary for it to meet its responsibilities.

- ☑ *Does not adequately explain its calculation of the assessment rate.*
  - ☑ *Spent \$19.9 million on capital improvement projects in the last two fiscal years and has appropriated \$12 million more, even though it does not have current strategic and capital improvement plans.*
  - ☑ *Invested in projects without understanding their full costs or ensuring that it would receive the benefits it anticipated.*
  - ☑ *Paid for services not covered under contracts and has not enforced all the terms of its contracts.*
  - ☑ *Lacks written purchasing procedures and has not adequately enforced its existing policies.*
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The district's ability to build the reserves to pay for these needs may be complicated by legal constraints. Beginning in fiscal year 2000–01, the water code limited the district's reserve fund balance to \$10 million, an amount that the district may adjust in subsequent years to reflect changes in the annual cost of the district's water purchases. In addition, the water code states that the district must earmark at least 80 percent of its reserves for water purchases, leaving the remainder for all other purposes. Because the district has not analyzed its other needs for reserve funds, however, it cannot state definitively that the 20 percent allowed for these needs is not enough.

Compounding the situation, the quantity of groundwater stored in the basins has declined by more than 110,000 acre-feet between October 1998 and September 2001, eroding about 30 percent of the progress made in replenishing the basins since water year 1961–62. The district has not established an optimum quantity for groundwater it should store or a minimum quantity it needs to assure an adequate supply of water to the basins' users. Without establishing targeted groundwater quantities, the district cannot fully justify its water purchase expenditures.

To ensure that it has sufficient funds to meet its statutory responsibilities, the district should adopt a policy on a minimum reserve fund balance. That policy should specify the amount of reserves it requires to meet all of its necessary expenses, including those associated with its operations, the stabilization of its assessment rate, its ability to respond promptly to contamination issues, and its ability to repair and replace its facilities and equipment. If the district determines that it needs more reserve funds than the water code currently permits, it should consider seeking legislative approval for an increase in the allowed level.

To ensure an adequate supply of water for the basins' users, we also recommended that the district establish an optimum quantity for stored groundwater that can serve as a target for its water purchases. It should also establish a minimum quantity below which it should not allow the basins to fall.

***District Action: Pending.***

The district states that it will make a recommendation to its board of directors (board) and the board will adopt a new reserve policy prior to adopting the fiscal year 2003–04 budget. That policy will be the basis for seeking legislative approval of statutory changes to the water code in the next

legislative session. In addition, the district states that district staff are currently working on a plan to establish optimum and minimum water quantities for stored groundwater.

**Finding #2: Several factors have contributed to the depletion of the district's reserve funds.**

Since fiscal year 1997–98 the district has depleted its reserve fund balance through a combination of lowered assessment rates, increased water replenishment purchases, capital improvement expenditures, and grants to ratepayers, totaling \$30 million, through its Clean Water Grant program. However, the district's past decisions indicate that it lacks a long-term vision for its finances, which has led to poor management of its reserve funds and of the assessment rate it charges ratepayers.

After years of increases in its assessment rate, resulting in a historical high of \$162 per acre-foot in the mid-1990s, the district lowered its rates beginning in fiscal year 1997–98. By fiscal year 2000–01, the district charged \$112 per acre-foot, a rate that it continued in fiscal year 2001–02 even though its annual Engineering Survey and Report (engineering report) and budget efforts indicated that it should have charged the maximum allowable rate of \$116 per acre-foot.

Under current statutory restrictions the district can only charge \$117 per acre-foot in fiscal year 2002–03. In its draft 2002 engineering report, the district estimates that water replenishment costs alone will account for \$112 of the \$117 proposed rate. This leaves only \$5 per acre-foot for the district's other expenditures, which for fiscal year 2002–03 the district estimates to be \$37 per acre-foot. The district's proposed budget for fiscal year 2002–03 indicates that if it adopts this assessment rate, it must make cuts in either water purchases or capital improvement project spending in order to balance its budget and provide for a minimum level of reserve funds.

The district cannot immediately recover financially from its past decisions. Currently, the water code limits the district to raising its rate by the local consumer price index (CPI) plus 1 percent, with a maximum 5 percent increase above the previous year's assessment. However, the CPI may not be the most appropriate index by which to restrict assessment rate increases since it is reflective of consumer inflation, not necessarily of increases to

the district in its cost of water purchases. This limitation is set to expire on December 31, 2002, although the Legislature may choose to extend that restriction.

Complicating the district's finances, current law prohibits the district from incurring debt to pay for capital improvement projects. Under the district's interpretation, in addition to prohibiting the district from selling bonds, this provision also prevents the district from incurring debt to take advantage of state-operated programs to assist in groundwater recharge and storage projects. This provision of the law also expires on December 31, 2002, unless the Legislature extends it.

We recommended that the district's board set the annual replenishment assessment at a rate that will support the district's planned activities and ensure that it maintains the level of reserve funds it needs to meet its statutory responsibilities. Furthermore, if restrictions on increasing assessment rates are extended past December 31, 2002, the district should consider seeking legislative approval of statutory changes that will increase its flexibility to raise funds for its operations, capital improvement projects, and reserves.

***District Action: Pending.***

The district states that it will determine the assessment rate that is required to maintain an adequate reserve balance.

***Legislative Action: Legislation passed.***

Assembly Bill 1163 (Chapter 941, Statutes of 2002) was enacted in September 2002 to delete the prohibition on the district to incur debt. The restrictions from prior legislation regarding limits on annual increases in the district's assessment rate expired on December 31, 2002. This bill also includes a provision that requires the state auditor to perform an audit of the district's operations and management and an evaluation of the extent to which the district has complied with recommendations the state auditor reported in May 2002. The state auditor shall submit its audit report to the Legislature no later than June 30, 2004, and the cost of the audit shall be reimbursed by the district's ratepayers.

**Finding #3: Due to shortcomings in the district's budget process, its spending needs do not tie to its assessment rate.**

The amount the district determines it must collect from the replenishment assessment is driven in part by the costs it budgets for capital improvement projects and other programs. However, in reviewing the district's fiscal year 2001–02 budget, we found that the district's staff have been inconsistent about including supporting information, their preparation of certain elements of the budget has been inaccurate, and they have allocated shared administrative costs inappropriately. The district has not exercised strong managerial oversight over its budgeting process, nor has it provided the staff who prepare the budget with sufficient, documented direction.

In addition to weaknesses in preparing its spending plan, the district does not tie its affirmed spending needs to the assessment it levies on ratepayers who pump groundwater from the basins. Moreover, the data contained in the annual engineering reports that the district prepares to meet certain requirements of the water code and identify water replenishment needs does not clearly explain the amount of water the district determines it must purchase. As a result, ratepayers have criticized the district over the validity of its budgeted expenses and the need for the assessment rate it charges.

We recommended that the district implement comprehensive written procedures for preparing its annual budget. These should provide staff who prepare the budget with adequate direction in meeting the standards that the district's management and directors develop for supporting information, overhead allocation, proper classification of expense items, and document retention.

To allow for a thorough public discussion of the district's proposed assessment rate, district staff should tie the district's spending plan to its calculation of the rate. The district should distribute this presentation to the board for public hearings and should distribute to attendees a presentation that includes, at a minimum, adequate data to support the proposed rate. This data should be drawn from the district's engineering report, proposed budget, and capital improvement plan.

***District Action: Partial corrective action taken.***

The district states that its controller has already issued preliminary policies and procedures and assumed responsibility for maintaining a central budget file. The controller is also responsible for the continued implementation of written policies and procedures over budget preparations. By the end of March 2003 the controller will finalize and distribute these policies to staff.

**Finding #4: The district lacks updated strategic and capital improvement plans.**

The district does not have current strategic and capital improvement plans that identify and prioritize the implementation of its capital improvement projects. Without such plans, the district cannot be certain that it identifies and implements the projects with the greatest impact on the supply of safe water in the basins. In addition, these plans can be important for giving the district's taxpayers a clear view of the long-term direction of the district and a better understanding of its ongoing needs for revenue to fund capital improvement projects. The district is creating a strategic plan to replace the plan it prepared in 1998. Although its ability to begin new projects is limited by its low reserve funds and legal restrictions that prohibit it from incurring debt, the district has spent \$19.9 million on capital improvement projects in the past two fiscal years and has earmarked another \$12 million for current projects. Moreover, the legal constraints are scheduled to expire on December 31, 2002, unless the Legislature extends them. Current strategic and capital improvement plans are therefore crucial to the district's ability to effectively and efficiently meet its statutory responsibilities. We believe that the most effective process for developing these plans would include the participation of those whom the district's programs and projects most affect, the district's ratepayers.

We recommended that the district continue to create an updated strategic plan and capital improvement plan to identify the programs and capital improvement projects that will aid it in fulfilling its mission. These plans will be most beneficial to the basins the district serves if the district incorporates the following activities into their development:

- Assess all activities it performs and their priority to the district's role versus the activities and roles of other water agencies in the region.

- Ensure that the plans clearly identify which projects are ongoing and prioritize the proposals in the order of importance to meeting the district's statutory requirements.
- Share with ratepayers the appropriate level of information on proposed programs and projects, including cost and benefit estimates.
- Periodically update its strategic and capital improvement plans to ensure that it bases decisions for future projects on appropriate and current information.

***District Action: Pending.***

The district reports that it is in the process of updating its strategic plan and has held three public workshops to solicit stakeholder input into the strategic planning process. The district states it has developed a draft capital improvement plan, including projects and programs that are clearly identified as new or ongoing. The district anticipates the plans will be ready for board adoption by mid-2003. In addition, the district will develop a policy for periodically updating strategic and capital improvement plans.

***Legislative Action: Legislation passed.***

Assembly Bill 1163 was enacted in September 2002 to require the district to develop and update a 5-year capital improvement program using input from a technical advisory committee made of water professionals appointed by the Central Basin Water Association and the West Basin Water Association (technical advisory committee).

**Finding #5: The district has failed to identify and resolve risks in proposed capital improvement projects.**

Despite the fact that over the past two fiscal years it has spent \$19.9 million on capital improvements, the district lacks a standard process for identifying and resolving the risks attached to potential projects and for evaluating the projects' costs and benefits. As a result, the costs of some projects are likely to exceed the district's estimates, and it may not gain the benefits it expected. For instance, the district invested \$10.3 million in the Goldsworthy Desalter facility (desalter) to remove saltwater contamination from the West Coast Basin without seeking clarification as to whether it would need legal rights to pump the saltwater from the basin. When the district sought this

clarification, the court determined the level of salinity of the extracted water necessary to exempt the district from obtaining legal pumping rights to be higher than the district had planned when it built the desalter. If the water pumped by the district does not reach that level of salinity, the district's operating costs will increase or it may have to invest up to an additional \$2.3 million to qualify the desalter for a subsidy of its operating costs.

In addition, the district started construction in October 2001 on the Alamitos Barrier Recycled Water Project (Alamitos Barrier project), which the district estimates will cost \$11.7 million, even though it has yet to resolve a critical issue that may keep it from operating. It has not yet reached final settlement with Los Angeles County (county) on an agreement to compensate a third party affected by the project, even though the district first identified the need to resolve this condition as early as 1997. The Alamitos Barrier project is scheduled for completion in November 2002, but without a resolution to this issue, the district will not be able to begin operating the facility.

In our December 1999 audit report, we recommended that the district standardize its process for preparing cost-benefit analyses for the capital improvement projects it considers for development. However, the district has not yet implemented such a policy. In a cost-benefit analysis, the district should define and evaluate the costs and perceived benefits of a proposed project and alternative projects, thus allowing it to make reasonable, informed decisions and to choose between different strategies. Further, the district should follow a consistent approach in preparing its analyses in order to avoid skewing the results in favor of projects it wants to do. Although the district states that it regularly conducts financial evaluations of its capital improvement projects, it does not have documented procedures for its staff to follow in performing cost-benefit analyses. The lack of a standard policy may result in inconsistent or poor analyses, which in turn may cause the district to forgo beneficial projects or spend its limited funds on less-desirable alternatives.

The district should establish a standardized approach to evaluating and selecting capital improvement projects. At a minimum, the approach should include the appropriate steps to identify legal, technical, and financial risks of proposed projects. Also, the district should implement a cost-benefit analysis methodology that (1) defines standards and

assumptions to use when evaluating replenishment projects and (2) offers a process for weighing alternative solutions to contaminant mitigation issues.

Moreover, the district should quickly define potential resolutions to the water rights issue involving the desalter and implement the most suitable solution to put the desalter to work permanently removing saltwater from the West Coast Basin. In addition, the district should promptly come to agreement with the county to resolve the third-party compensation issue that could potentially prevent the operation of the Alamitos Barrier project.

***District Action: Partial corrective action taken.***

The district states that after it has completed updating its strategic plan, and in cooperation with the technical advisory committee, it will develop a standardized approach to identify the legal, technical, and financial risks of proposed capital projects. Once the cost and benefits of proposed projects are identified, the district will seek recommendations from the technical advisory committee and board approval to move forward with a particular project. In addition, the district reported that it had received from the court an extension of time for its desalter to reach the chloride levels required in the operating criteria. In November 2002, the desalter reached those levels and the district is preparing the reports to substantiate its compliance to the court. Finally, the district and the county have finalized the resolution to the issue related to the Los Alamitos Barrier project.

**Finding #6: The district has not managed all of its contracts effectively.**

The district has not always signed contracts prior to receiving and paying for professional services and has at times paid for services that are not included in the scope of its contracts. For example, the district paid one of its general counsels almost \$112,000 during 2001 for the services of a public relations firm, even though the general counsel's contract did not include public relations in its scope or authorize the hiring of subcontractors.

Also, the district's current contracts with three legislative advocacy firms and three law firms do not specify the duration of the agreements. The district entered into most of these

contracts between 1998 and 2000, although one dates to 1989. For the six firms combined, the district paid more than \$1.4 million in 2001. Although the district correctly points out that it signed the contracts prior to the current requirement that all contracts contain duration, we believe the current requirement reflects sound business practice for all contracts.

Moreover, the district did not enforce the terms of one of its contracts on which it paid a fixed amount of \$21,500 per month, and district staff did not follow the board's policy or instructions when signing another contract for which it paid \$25,000 in 2001. The district has also entered into agreements with legal, legislative advocacy, and public relations firms for fixed monthly fees of up to \$10,000 per month, but it could not provide evidence that it regularly reviews its needs for these services. As a result, it may be paying for unneeded services or overpaying for the value it receives. Finally, the district does not maintain an adequate file of its contracts. In two instances we found that the district maintained duplicate contracts for legal and legislative advocacy services.

In spite of the lingering weaknesses in the district's management of its contracts, some provisions imposed by the water code and the district's Administrative Code (district code) appear too restrictive. In response to our December 1999 audit report, one requirement the Legislature placed on the district's contracting practices requires that the board president and secretary sign all contracts and other documents that the district enters into. Although this requirement allows the district's board complete oversight of contracting practices, it has the potential of being administratively burdensome for contracts below certain dollar thresholds. Similarly, the district enhanced the contracting provisions in its policies by adopting certain portions of the California Public Contract Code into the district code. However, one of the provisions in the district code places burdensome restrictions on the district's contracting practices by requiring a formal written process for requesting proposals for most contracts and requires board approval of all contract solicitations for professional services, regardless of dollar amount.

To ensure that it maintains the proper level of control over the services it receives from various consultants, we recommended that the district improve its contract management procedures by taking the following steps:

- Develop scope-of-services provisions for its contracts that clearly define the tasks it requires from contractors and provide the district with clear criteria for evaluating the contractors' performance.
- Ensure that the district and professional services contractors sign a written agreement.
- Specify duration that identifies a starting point and ending point in all contracts.
- Ensure that it enters into contracts that are consistent with the board's directions and that contracts are signed only by those authorized to do so.
- Separate contracts into active and inactive files to facilitate easier identification of the contracts under which it may have obligations.

We also recommended that the district renegotiate existing contracts so that they are consistent with current minimum standards that the Legislature mandates, which require scope-of-service, duration, and payment terms.

To ensure that it receives all of the services and products that its contracts specify, the district should assign staff of appropriate levels to monitor the contractors' performance. Moreover, the district should implement procedures to periodically evaluate any contracts that require fixed monthly fees to ensure that it receives services in keeping with the fees it pays.

Finally, we recommended that the district consider seeking legislative changes to the water code to allow the board to delegate the authority to sign contracts and amend the district code to allow more efficiency in procuring goods and services.

***District Action: Partial corrective action taken.***

The district states that it is taking steps to strengthen its contract management policies and procedures, including assigning management staff to serve as contract managers, reviewing current contracts to ensure they comply with applicable legislative mandates, and implementing annual quality reviews of services before renewing any contracts. In addition, the district intends to seek legislation amending the water code to allow the board to delegate the approval and signing of contracts below certain dollar thresholds to the district's general manager.

**Finding #7: Despite amendments to its policies, the district could further improve its controls over purchases and travel reimbursements.**

Although it has improved its procurement policies, the district could further improve its controls over purchases of goods and services, as well as reimbursements to staff, consultants, and board members for travel costs. At the time of our audit, the district lacked written accounting procedures to govern cash disbursements and purchasing. This lack of standardized procedures has led to inconsistent practices and insufficient managerial control over purchase and payment approvals—in fact, at the time of our review, the district had no formal requirement that managers preapprove purchases. Although many of these payments are small compared to the district’s overall spending, the lack of adequate controls can promote a culture that is contrary to the stewardship imposed on the district as a public agency.

Further, the district has not always ensured that the costs its directors incur for conferences and travel are reasonable and necessary, as the district code requires. Consequently, the district may not be benefiting from all of the conference and travel costs it reimburses. For example, it reimbursed two of its directors a total of more than \$7,700 for travel and conferences without documentation of the reasonableness of their expenses and the benefit of the trips to the district.

In addition, the district has not adequately controlled reimbursements to managers, directors, and consultants for travel and meal expenses. The district’s policy states that employees can be reimbursed for travel and meal expenses, within defined dollar limits, only outside a defined local area, and requests for expense reimbursement must be submitted within 90 days. However, we found that the district reimbursed its interim general manager \$915 for local meals purchased over a nine-month period, reimbursed one director for meal expenses in excess of the established limits, and reimbursed consultants nearly \$3,000 without obtaining the business purpose of the expenses.

We recommended that to better control its administrative costs, the district should continue its development and implementation of written accounting procedures. It should ensure that these procedures require that only authorized staff approve purchases of goods and services and approve payments

to vendors or consultants, and staff maintain documents that demonstrate efforts to ensure that the district receives value for purchases that do not require formal bidding.

Before approving reimbursement for travel or conference costs for its members, the district's board should ensure that travel or conference costs will benefit the district's public purpose.

We also recommended that the district adopt a policy that holds contractors to the same expense reimbursement guidelines as district staff.

***District Action: Partial corrective action taken.***

The district reports that its controller is responsible for the continued development and implementation of written accounting procedures. The controller has issued preliminary policies and procedures and distributed them to staff and will finalize and distribute additional policies and procedures in the near future. Those policies and procedures include requirements for reimbursement of travel or conference costs for district staff, board members, and district contractors.

**Finding #8: The district's administrative code could provide better guidance on procurement.**

The district's policies continue to omit some critical elements of contracting practices that we identified in our previous report. Specifically, the district code does not prohibit staff from writing requests for proposals that effectively limit bidding to one bidder or altering requirements that could affect the evaluation of the bids after the district issues final requests for proposals. In addition, the district code broadly exempts certain contracts, such as those for retaining expert witnesses to provide consulting or testimony, from its procurement policy.

In addition, the district code is silent on the board's position as to which types of expenditures promote the district's public purpose. During 2001 the district spent more than \$500 for flowers for employees, directors, and nonemployees; it also spent almost \$3,500 for its annual holiday party. However, we did not find a district policy that establishes a reasonable basis for its position that these expenses support the district's public purpose, and as a result, we believe that these payments are gratuities and thus a gift of public funds. The district also paid \$2,000 to co-sponsor a dinner at the National League of

Cities annual conference in Boston, Massachusetts. The district justified the cost by stating that many Los Angeles-area cities had representatives at the event, but otherwise it could not demonstrate how the expense furthered its public purpose, nor could it provide evidence that the board considered the necessity and reasonableness of the expense before approving it.

Finally, as we noted in our previous report, the district code does not provide adequate guidance in its travel reimbursement policies, rather, it requires only that the lodging be moderate and necessary. In the absence of adequate policies and procedures, the district paid room charges of up to \$280 per night for hotel stays in Sacramento, where less expensive lodging is widely available.

We recommended that the district amend the district code to provide the following:

- Requests for proposals that do not effectively eliminate bidders. In addition, it should prohibit altering material factors that could affect the evaluation of bids after it has issued final requests for proposals.
- Better guidance to district staff on allowable and unallowable expenses. Specifically, the board should adopt a policy regarding the types of expenses it believes promote the public purpose of the district.
- Better guidance for reimbursable lodging expenses, including dollar thresholds and a process for justifying charges in excess of those thresholds.

***District Action: Partial corrective action taken.***

The district states that it will further amend its district code to ensure consistency with relevant state water code provisions. In particular, the district will work to update its code to provide clear guidelines on allowable expenses and define appropriate reimbursable lodging expenses.

**Finding #9: The district has not fully complied with mandated reporting requirements.**

Amendments to the water code require that, effective January 1, 2001, the district present estimates of the costs to complete and the funding sources for its capital improvement

projects in its annual audited financial statements and that it also include a report from its independent auditor evaluating the propriety of its operating expenses. However, the district included an incorrect list of capital improvement projects in its audited financial statements and overstated their estimated costs by \$3.6 million. In addition, the district did not include the required report on the propriety of its operating expenses.

Although the water code limits the amount of reserve funds the district may accumulate, it does not require the district to disclose its compliance with this provision in its audited financial statements. In its June 30, 2001, financial statements, the district voluntarily included a calculation intended to show that it complied with the water code's restrictions. However, the district erred in its calculation and understated its accumulated reserve funds at June 30, 2001, by \$4 million. Although it exceeded the water code's limitation of \$10 million in reserve funds for fiscal year 2000–01, the district has properly applied the excess to capital improvement projects and water purchases in its fiscal year 2001–02 budget.

We recommended that to provide reliable information on its operations as the Legislature intended, the district take the necessary steps to ensure that it complies with the reporting requirements of the water code. It should include in its audited financial statements an accurate and complete list of its capital improvement projects and their funding sources as well as a report on the propriety of the district's operating expenses. In addition, the district should ensure that it accurately calculates any disclosure of reserve funds it includes in its audited financial statements.

***District Action: Corrective action taken.***

The district submitted audited financial statements for fiscal year ended June 30, 2002, that include the reporting requirements of the water code.

